INLAND REVENUE BOARD OF REVIEW DECISIONS

Case No. D127/98

Profits Tax – whether profits from the sale of a property assessable to profits tax – section 68(4) of the Inland Revenue Ordinance.

Panel: Christopher Chan Cheuk (chairman), Erwin A Hardy and Jiang Zhaodong.

Date of hearing: 24 September 1998.
Date of decision: 4 December 1998.

The taxpayers (Mr A and Mr B), both were practising solicitors, appealed against a profits tax assessment for the year of assessment 1989/90 arising out of the purchase and sale of a property ('the Property') on the ground that the gain derived from the disposal of the Property was capital and should not be chargeable to profits tax.

Held:

1. The Board would adopt the approach suggested by Mortimer J in All Best Wishes Limited that 'the stated intention of the taxpayer cannot be decisive and the actual intention can only be determined upon the whole of evidence'.

2. The background of Mr A and the fact that he was fully aware of the two properties sharing a common staircase made it rather unusual and difficult for the Board to believe that Mr A had not made a land search on the Adjoining Property at the time they decided to acquire the Property.

3. Although Mr A claimed that the decision to acquire the Property had to be made within a short period of time, Mr A did not tell what happened to Mr B who was also a solicitor. The Board, which understood that a land search did not require much time or effort, did not find any good reason for not making the land search concerned.

4. Mr A in evidence did say that in comparison with the Adjoining Property the price was high. If it were high what was the hurry? Except that he knew there was redevelopment potential, otherwise he should not have bought it.

5. The point that the decision to acquire the Property had to be made within a short period of time seemed to support Mr A's argument that he had not made the search. However, this was not so because when he had made the search and discovered that the Adjoining Property was saleable he would

have realized that there was good redevelopment potential and was more eager to buy the Property.

6. If the taxpayers were really so concerned about the rental yield, they as practising solicitors (one being specialized in the area of real estate conveyancing and the other in general practice who was faimilar with tenancy matters) should have enquired which part of the Landlord and Tenant (Consolidation) Ordinance (Chapter 7) applied to the Property. The taxpayers thought that the Property was built before the war and the domestic part was protected under Part I of Chapter 7. Later they were told to be wrong. Mr A did not remember whether they had applied for a copy of the occupation permit to ascertain the date when the building was completed. Nor did they try to find out whether the Property was protected by Part I. If rental were their primary objective for the acquisition they should have gathered more information and should have done much more than what they did.

7. The calculation that the gross annual return on the investment based on a cost of $3,400,000 was around the region of 15.5%, estimated by the taxpayers at the time of acquisition, was misleading because it had not taken into consideration other factors like interest on loan, and property tax etc.

8. Besides, the fact that the actual amount invested by the taxpayers was much less than $3,400,000 as $2,000,000 came from bank loan showed that the calculation of the gross annual return on the investment was not a genuine calculation of costs and profits. Nor was it a reflection of the actual yield. Any serious investor would do more serious calculation than what was present to the Board.

9. No long-term plan was disclosed as to how the Property was held and let out, and how and who would keep the income and expenditure accounts. The Board was left with an impression that the holding was transitory. They had no forward planning. What they had done was nothing more than issuing notices of termination or application to increase rent.

10. Their explanation that it took at least half a year to vacate the tenants or to increase the rent because of the legal process and therefore it was not necessary to make any forward planning yet, could also be considered to be consistent with the proposition that they wanted to obtain vacant possession. Would a serious investor buy a property with so many unknown factors for long term purpose? Would a first time buyer purchase such property with so many uncertainties without some forward planning?

11. The Board accepted that an offer of $12,000,000 with a net profit of over $8,000,000 within a short period of 7 months was very attractive. It was a

sum substantial enough to disregard the possible embarrassment they might have for the good relationship with the former owner of the property.

12. Having considered all circumstances of the case, particularly the taxpayers' background and that of Mr A's father, the Board have great reservation on the proposition that the taxpayers were not aware of the redevelopment potential of the Property at the time of acquisition.

13. Having seen Mr A's demeanour and having heard what he said, the Board were not convinced that they (taxpayers) intended to hold the Property as a long term investment at the time of purchase.

14. Taking all the evidence as a whole, the Board were not able, by balance of probabilities, to come to the conclusion that the taxpayers had genuine intention to acquire the Property as a long term investment or to hold the Property at the time of acquisition as a capital asset.

15. Section 68(4) of the Inland Revenue Ordinance placed the burden of proof on the taxpayers, the Board found that they have failed to discharge this duty.

Appeal dismissed.

Cases referred to:

All Best Wishes Limited v CIR 3 HKTC 750
D77/96, IRBRD, vol 11, 698

Chan Wai Mi for the Commissioner of Inland Revenue.
Thomas Li of Messrs Moores Rowland for the taxpayer.

Decision:

Appeal

1. This is an appeal by Mr A and Mr B (both Mr A and Mr B together are referred to as 'the Taxpayers') against the determination made by the Commissioner of Inland Revenue on 1 May 1998 in respect of a profits tax assessment for the year of assessment 1989/90 arising out of the purchase and sale of the property in District C ('the Property').

Proceedings

2. Both Taxpayers are practising solicitors and Mr B has duly authorised Mr A to represent him. Mr A and the presiding chairman of the Board were of the same profession and the latter declared that he knew Mr A on professional basis. Parties to this action confirmed to the Board that they had no objection for Mr Chan to continue to act as presiding chairman and to hear the case.

3. Mr A gave evidence on oath for his own behalf as well as for Mr B. Before the hearing the parties had agreed certain facts and reduced them into a document known as statement of agreed facts which was produced as an exhibit.

Primary facts

4. The statement of agreed facts consists of 13 paragraphs which can be briefly summarised in the following chronology:

25 November 1988	The Taxpayers entered in an agreement for purchase of the Property at a price of $3,400,000 subject to existing tenancies
16 December 1988	Completion of the purchase
19 December 1988	Notices of termination were issued to the tenants of ground floor and first floor of the Property
24 April 1989	The Taxpayers entered into an agreement for sale of the Property at a price of $12,000,000
31 May 1989	Completion of the sale took place. After deducting all expenses the Taxpayers made a profit of $8,113,194

Ground of appeal

5. The ground of appeal is a simple one as set out in the letter dated 27 May 1998 from Messrs Thomas LI & Company Ltd to the Clerk to the Board: '*the gain derived from the disposal of the Property located at District C is capital and should not be chargeable to profits tax.*' The parties confirmed that the quantum itself, that is, the amount of assessed tax of $1,216,979 was not in dispute.

The Taxpayers' case

6. Mr A in his testimony stated that both Taxpayers were practising lawyers with relatively good yearly income. The purchase of the Property and the profits from sale were fortuitous. They never had any dealing in property. Neither did any of them own any real property before the acquisition.

7. Mr A's father formerly worked as a supplier of sanitary ware in a publicly-listed company and came to know a number of developers. Among them was a certain Mr D. Mr A's father and Mr D became good friends; sometimes Mr A's father participated in Mr D's redevelopment projects but played a small and passive role. At a lunch gathering around early November 1988 Mr A's father learned of Mr D's intention to sell the Property of three-storey old building at a price of $3,400,000. This was the price, which Mr A later discovered, offered by the purchaser of the adjoining property ('the Adjoining Property'). Mr A's father considered the purchase to be a good investment.

8. Mr A confided this to his good friend Mr B and discussed with him about the viability of the investment. Mr B took more active step and consulted his surveyor friend Mr E who indicated that the market rental for a shop in that vicinity was around the region of $45 to $55 per square foot on usable area basis. Mr B wanted to participate in the acquisition.

9. Soon they visited and inspected the Property, and viewed the surroundings. It was located at District C near the road junction. The Property was over forty years old but were reasonably well maintained. The ground floor was occupied by a tenant carrying on the business of selling car radios, car cassette-recorders and other car accessories. They were of the opinion that there was good prospect of increasing the rental yield to a region of 15.5% of the cost of $3,400,000. They decided to purchase the Property and arranged a bank loan of $2,000,000 to be repaid by 84 monthly instalments.

10. After the purchase the Taxpayers took immediate steps, which Mr A claimed, for the purpose of increasing rent: they caused Messrs C Y Kwan & Co, of which he was a partner, to issue notices of termination to the tenants of the ground and first floors; they engaged Mr E to conduct physical inspection of the Property to ascertain and confirm that the primary user of the ground floor was non-domestic; and Mr A on behalf of the Taxpayers applied also for a certificate of standard rent in respect of the second floor.

11. About two or three months after the purchase Mr A was approached by a certain Mr F who claimed to represent Company G, the owner of the Adjoining Property. Mr F first made an offer of $4,000,000 to buy the Property and later increased it to $5,000,000. It was rejected by the Taxpayers as they intended to hold the Property for the purpose of long-term investment and the quick sale with profit would cause embarrassment to Mr A and his father in the light of the latter's good relationship with Mr D.

12. Some time later Mr F came back again and this time claimed to represent a China-related buyer who was prepared to pay a higher price of $10,000,000 but on condition that it could acquire both the Property and the Adjoining Property together. Later, the offer was increased to $12,000,000 which was a price difficult to resist even though they had to pay a commission of $300,000 representing 2.5% of the purchase price.

13. Mr Thomas Li ('Mr Li'), the tax representative for the Taxpayers, submitted the following points for us to consider:

(a) The Property, an old building, was ***'reasonably maintained'*** as described by Mr E, the surveyor.

(b) It was by coincidence that the Taxpayers acquired the Property.

(c) The price was not cheap and at least it was much higher than that of the Adjoining Property which was sold four months earlier only at a price of $2,000,000 to Company G.

(d) Mr Li submitted that the Taxpayers could not have been aware of any opportunity to sell the Property within a short period of time.

(e) The Taxpayers had the financial ability to acquire and hold the Property.

(f) The Taxpayers did not jump into the opportunity to purchase the Property; they made inspection, sought the advice of a surveyor friend and checked with bank for loan etc.

(g) The Taxpayers projected a yield of 15.5% on the investment made.

(h) The Taxpayers did all the necessary for the increase of rent.

(i) The Taxpayers did not know of the sale and purchase of the Adjoining Property which occurred some three or four months ago. The Taxpayers did not make a land search on the Adjoining Property.

(j) The Taxpayers did not advertise the Property for sale. It was Mr F who approached Mr A for the sale.

(k) The price offered, that is, $12,000,000 was too good an offer to resist; even the owner of the Adjoining Property, which was a medium size development company, also agreed to sell its property.

(l) Mr Li urged us to follow the dictum of Mr Justice Mortimer in the case of All Best Wishes Limited v CIR 3 HKTC 750 at 771 that *'an investment, of course, does not become trading stock because it is sold.'* Mr Li also drew our attention to the Board's decision in D77/96, IRBRD, vol 11, 698 at 708 which has the following comment *'Yet, however significant a short-term holding can be (and in many cases it is a critical factor), it can be neutralized by cogent reason for sale.'* We think that the cogent reason for sale referred to by Mr Li was the very attractive price and no reasonable person could resist the offer.

Analysis

14. The Taxpayers expressly stated that they acquired the Property as a long-term investment. However, we wish to adopt the approach suggested by Mortimer J in All Best Wishes Limited (above) that *'the stated intention of the taxpayer cannot be decisive and the actual intention can only be determined upon the whole of evidence'*. We shall examine all the circumstances of the case.

15. Mr A told us with special emphasis at the hearing that he had not made a land search on the Adjoining Property at the time they decided to acquire. This point was also highlighted by Mr Thomas Li during his submission. They raised this issue because they wanted to stress the point that they were not aware of the Property's redevelopment potential. Mr D, the seller, who held the Property for over ten years since 1977 and finally decided to sell it partly because he was frustrated as the chance of developing jointly with the Adjoining Property was rather slim and the redevelopment of the Property on its own was not a financially sound proposition. Further, Mr D intended to emigrate shortly. His decision to sell was made known to Mr A's father in November 1988. Incidentally, in July 1988, about four months ago, the Adjoining Property was sold. Mr A stressed that he did not cause any land search to be made on the Adjoining Property and he was not aware of the sale. This is rather unusual and difficult for us to believe for the following reasons:

(a) He was an experienced conveyancing lawyer and he was fully aware of the two properties sharing a common staircase. It is not unreasonable to expect that he should have ascertained the actual right of way before commitment by making land search on the Property as well as the Adjoining Property.

(b) He told us that he and his friend Mr B had no experience in real property dealing. His father told him that it was a good investment. He did not make any further enquiry. In fact, the easiest method was to cause a land search on the nearby premises. Had he done so he should have discovered that an agreement for sale and purchase was registered against the Adjoining Property. We doubt his generalised statement that registration of an agreement would not be completed within three months and what he could find after the document had been lodged for registration for three months was only a record on the day book. When queried by the Chairman he shifted the emphasis to the matter about nomination which had been presented for registration 5 weeks before their purchase. Even if we were wrong, he could have found a note in the day book that an agreement for sale and purchase had been registered. The conclusion he could draw was that the Adjoining Property was no longer held up by the lack of probate or letters of administration.

The explanation he gave for not causing the land search was that he was very busy. He was preparing for his wedding which took place on 12 November 1988. He was lecturing at the university for two courses and he was taking a post-graduate examination in December. The decision to acquire the Property had to be made within a short period of time. He did not tell us what happened to Mr B who was also a solicitor. We do not find any good reason

for not making the land search. We understand that a land search did not require much time or effort, particularly when it was done through a solicitor firm.

16. The pressure to make a quick decision came from the fact that Mr D had a standing offer from another purchaser. It was due to the good relationship with Mr A's father that Mr D was prepared to wait. This brings us to the question why the Taxpayers were so anxious to purchase the Property and did not wish to miss the opportunity. Mr A's father told him that it was a good investment. Mr B seemed to have checked it with Mr E, the surveyor whether the price was right. There was a loose sheet containing some comparables found at page 84 of the agreed bundle. It came with the draft report given to them after the purchase. Mr A told us that he did not see the report before they acquired the Property. Mr A did not seem to rely on this to ascertain whether the purchase price was right. Ms Chan for the Revenue rightly raised the suspicion about the completeness of the report that was presented to the Revenue and also now shown to the Board. Mr A in evidence did say that in comparison with the Adjoining Property the price was high. If it were high what was the hurry? Except that he knew there was redevelopment potential, otherwise he should not have bought it. The point seemed to support his argument that he had not made the search. This is not so because when he had made the search and discovered the Adjoining Property was saleable he would have realised there was good redevelopment potential and was more eager to buy the Property.

17. If they were really so concerned about the rental yield, they as practising solicitors (one being specialised in the area of real estate conveyancing and the other in general practice who was familiar with tenancy matters) should have enquired which part of the Landlord and Tenant (Consolidation) Ordinance (Chapter 7) applied to the Property. They thought that the Property was built before the war and the domestic part was protected under Part I of Chapter 7. Later, they were told to be wrong. Mr A did not remember whether they had applied for a copy of the occupation permit to ascertain the date when the building was completed. Nor did they try to find out whether the Property was protected by Part I. If rental were their primary objective for the acquisition they should have gathered more information and should have done much more than what they did.

18. Mr A had an explanation for the above. He was more concerned about the possibility of rental increase relating to the ground floor shop than any other matter. He gave us some figures. They expected that they might increase the monthly rent to the region of $38,000 to $40,000 for the ground floor shop. Together with rents from other floors they estimated that they would get about $44,000 from the letting of the Property. They thought that the gross annual return on the investment based on a cost of $3,400,000 was around the region of 15.5%. This was their calculation at the time of acquisition. A member of the Board pointed out, a view which the other members also shared, that such calculation was misleading because it had not taken into consideration other factors like interest on loan, and property tax etc. Mr Li for the Taxpayers in reply commented that the actual amount invested by the Taxpayers was much less than $3,400,000 as $2,000,000 came from bank loan. All these show one thing that the calculation was not a genuine calculation of costs and profits. Nor was it a reflection of the actual yield. Any serious investor would do more serious calculation than what was presented to us.

19. We were told that the capital contribution between the Taxpayers was at the ratio 7:3. They were good friends and we do not expect that there was a written document reflecting their agreed terms. If they had one, at least it was not shown to us. Neither were we informed how they serviced the loan during the interim period before sale or before the rent increase. Nor was any long term plan disclosed how the Property was held and let out, and how and who would keep the income and expenditure accounts. We were left with an impression that the holding was transitory. They had no forward planning. What they had done was nothing more than issuing notices of termination or application to increase rent. The explanation was that it took at least half a year to vacate the tenants or to increase the rent because of the legal process. Therefore, it was not necessary to make any forward planning yet. However, all these actions could also be considered to be consistent with the proposition that they wanted to obtain vacant possession. Would a serious investor buy a property with so many unknown factors for long-term purpose? Would a first time buyer purchase such property with so many uncertainties without some forward planning?

20. We accept that an offer of $12,000,000 with a net profit of over $8,000,000 within a short period of 7 months was very attractive. It was a sum substantial enough to disregard the possible embarrassment they might have for the good relationship with Mr D, the former owner. Having considered all circumstances of the case, particularly the Taxpayers' background and that of Mr A's father we have great reservation on the proposition that the Taxpayers were not aware of the redevelopment potential of the Property at the time of acquisition. Having seen Mr A's demeanour and having heard what he said we are not convinced that they intended to hold the Property as a long-term investment at the time of purchase. We have not made any observation whether Mr D was properly and fully advised at the time of sale. Neither do we want to enter into a full discussion about the assertion that compensation to tenant in redevelopment cases was directly related to the amount of rent received. Taking all the evidence as a whole we are not able, by balance of probabilities, to come to the conclusion that the Taxpayers had genuine intention to acquire the Property as a long-term investment or to hold the Property at the time of acquisition as a capital asset.

Conclusion

21. Section 68(4) of the Inland Revenue Ordinance puts the burden of proof on the Taxpayers. We find that they have failed to discharge this duty. Accordingly we dismiss the appeal.